Office of Chief Counsel
Internal Revenue Service

memorandum

CC:WR:SCA:SD:TL-N-113-00
GAKindel

date: JAN 18 2000

to: Examination Division, Southern California District
ATTN: Sandy McMullen, Exam Group 1104

from: Associate District Counsel, Southern California District, San Diego

subject: [redacted]

This memorandum responds to your request for advice concerning the procedures that you must follow in asserting that, pursuant to I.R.C. § 707(a), [redacted], a wholly owned subsidiary of [redacted] did not contribute certain restaurants to [redacted] but, instead, sold the restaurants to [redacted]

DISCLOSURE LIMITATIONS

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This advice is not binding on Examination or Appeals and is not a final case determination. Such advice is advisory and does not resolve Service position on an issue or provide the basis for closing a case. The determination of the Service in the case is to be made through the exercise of the independent judgment of the office with jurisdiction over the case.

ISSUE

Whether the Service must conduct an examination of [redacted] pursuant to the provisions of I.R.C. §§ 6221 et seq. before issuing a notice of deficiency to [redacted], where [redacted], a partner of [redacted] engaged in a transaction treated by the Service as a disguised sale, pursuant to I.R.C. § 707(a), between [redacted] and [redacted]

If so, (1) what types of notices must the Service issue to assert its position on the disguised sale and (2) what types of consents must the Service obtain to extend the period of limitations for partnership items and affected items?

CONCLUSION

Yes. The amount and character of the transfer of assets by [redacted] to [redacted] are partnership items. Therefore, they must be determined in a partnership level proceeding. And you must follow the procedures set forth in I.R.C. §§ 6221 et seq. Specifically, you should issue to each partner of [redacted] entitled to notice a Notice of Beginning of Administrative Procedure and a notice of Final Partnership Administrative Adjustment, if necessary.

The amount of gain realized by [redacted], if any, on the sale depends on the amount and character of the transfer described above as determined in the partnership proceeding. Therefore, the amount of gain is an affected item. After the decision in the partnership proceeding becomes final and within one year thereafter, you should issue an affected items notice of deficiency to [redacted] determining the amount of gain that [redacted] realized but failed to recognize in [redacted].

You should have the Tax Matters Partner of [redacted] execute Form 870-P, Consent to Extend the Time to Assess Tax Attributable to Items of a Partnership, to extend the 3-year period of limitations for partnership items prescribed by I.R.C. § 6229(a). I.R.C. § 6229(a) sets the period of limitations for assessment with respect to partnership items and affected items. Consequently, Form 870-P also serves as an extension of the period of limitations for affected items.

FACTS

Please review our memoranda dated January 29, 1999, and July 22, 1999, for a detailed statement of facts. Below is an abbreviated version of the facts.

I. PARTIES

[redacted] (the "Taxpayer") is a publicly held corporation organized under the laws of Delaware and engaged in the restaurant business. The Taxpayer is recognized for its [redacted] restaurants.

[redacted] ("[redacted]") is a Delaware corporation wholly-owned by the Taxpayer and incorporated in or about [redacted] for the purpose of acquiring certain rights in the [redacted] restaurants.

[redacted] ("[redacted]") is a Delaware corporation owned equally by [redacted] ("[redacted]") and [redacted] ("[redacted]"), the originators of the [redacted] concept.

[redacted] ("[redacted]") is a Delaware limited partnership formed in [redacted] owns a [redacted] percent general partnership interest in [redacted], while approximately [redacted] individuals together own a [redacted] percent limited partnership interest.

[redacted] ("[redacted]") is a Delaware limited partnership formed on [redacted] for the purpose of owning and operating [redacted] located in [redacted] and [redacted].

[redacted] ("[redacted]") is a Delaware limited partnership formed on [redacted], for the purpose of holding an interest in [redacted] is owned as follows:

Partner	Interest	Percentage
[redacted]	General Partner	[redacted]%
[redacted]	Limited Partner	[redacted]%

[redacted] is a Delaware corporation owned equally by [redacted] and [redacted].

II. BACKGROUND

The Taxpayer and its subsidiaries (including [redacted] file a consolidated return.

In the late [redacted]'s, the Taxpayer sought to expand its business to include restaurants that differed but complemented its [redacted] restaurants. Specifically, the Taxpayer became interested in a chain of casual restaurants named "[redacted] or "[redacted]."

In [redacted], [redacted] purchased development rights and a license to use the [redacted] name in [redacted] County and [redacted] from [redacted]. At the same time, the Taxpayer entered an operating agreement with [redacted] to operate existing [redacted] restaurants in [redacted] and [redacted].

In [redacted], [redacted] and [redacted] entered into an Amended and Restated Area Development and License Agreement ("Restated Development Agreement") in which [redacted] paid $[redacted] to obtain the exclusive right and license to establish and operate [redacted] restaurants throughout the world for a term of [redacted] years. [redacted] also was required to pay a [redacted] royalty fee equal to [redacted] percent of its gross sales from its [redacted] restaurants and to develop [redacted] new [redacted] restaurants for each of the first [redacted] years of the Restated Development Agreement.

By late [redacted], [redacted] owned and operated [redacted] restaurants, [redacted] in [redacted] (the "[redacted]"), [redacted] in [redacted] (the "[redacted]"), and [redacted] in [redacted] (the "[redacted]").

At this time, the Taxpayer adopted a plan to focus on the operations and long-term success of the core [redacted] business. The plan involved the selling of the [redacted] restaurants and the development of the [redacted] restaurants.

The Taxpayer approached [redacted] and [redacted] as potential purchasers of [redacted] restaurants. [redacted] and [redacted] agreed to repurchase from [redacted] the development and licensing rights in the [redacted] restaurants and to purchase the assets of the [redacted], [redacted] and [redacted] and [redacted], however, wanted to separate the [redacted] from the [redacted] and [redacted] because the [redacted] were not successful. As a consequence, the transaction was divided into [redacted] parts.

III. DISPOSITION OF [redacted] AND [redacted] RESTAURANTS

Upon the formation of [redacted], [redacted] contributed $[redacted] in exchange for a general partner interest of [redacted] percent. [redacted] contributed $[redacted] in exchange for a Class A Limited Partner interest of [redacted] percent and contributed the [redacted] and [redacted], valued at $[redacted], in exchange for a Class B Limited Partner interest of [redacted]%. Immediately following the formation of [redacted] [redacted] sold its [redacted]% Class B Limited Partner interest to [redacted] for a $[redacted] promissory note.

The Taxpayer reported a short-term capital gain of $[redacted] with respect to the sale of its interest in [redacted] on Schedule D, Capital Gains and Loss, attached to its [redacted] U.S. Corporation Income Tax Return, Form 1120. The Taxpayer computed the gain as follows:

Gross Sales Price	$[redacted]
Cost	[redacted]
Gain	$[redacted]

The cost identified equals [redacted] percent of the cost for the [redacted] and [redacted].

IV. EXAMINATION BY THE SERVICE

You have proposed to treat the transfer of the [redacted] and [redacted] by [redacted] to [redacted] as a disguised sale pursuant to I.R.C. § 707(a). In our memoranda dated January 29, 1999, and July 22, 1999, we acknowledged that your position has merit but recommended that you obtain additional information.

DISCUSSION

I. NOTICES

As stated above, you have proposed to treat the transfer of the [redacted] and [redacted] by [redacted] to [redacted] as a disguised sale pursuant to I.R.C. § 707(a). You have determined, as a result of this proposal, that the Taxpayer realized, but did not report on its 1996 Form 1120, gain on the sale of the [redacted] and [redacted]. Before you may issue a notice of deficiency to the Taxpayer asserting this determination, however, you must conduct an examination of [redacted] pursuant to the provisions of I.R.C. §§ 6221 et seq. (the "TEFRA partnership provisions").

The TEFRA partnership provisions establish separate procedures for determining the tax treatment of "partnership items" and make the standard deficiency procedures inapplicable to those items. I.R.C. §§ 6621 and 6230(a)(1). The Service, therefore, may not assess a deficiency attributable to a "partnership item" until after the close of a partnership proceeding. I.R.C. § 6225.

A "partnership item" is "any item required to be taken into account for the partnership's taxable year under any provision of subtitle A to the extent regulations prescribed by the Secretary provide that, . . ., such item is more appropriately determined at the partnership level than at the partner level." I.R.C. § 6231(a)(3). Items that are more appropriately determined at the partnership level than at the partner level include, among others:

> Items relating to the following transactions, to the extent that a determination of such items can be made from determinations that the partnership is required to make with respect to an amount, the character of an amount, or the percentage interest of a partner in the partnership, for purposes of the partnership books and records or for purposes of furnishing information to the partner:
>
> (i) Contributions to the partnership;
> (ii) Distributions from the partnership; and
> (iii) Transactions to which section 707(a) applies (including the application of section 707(b)).

Treas. Reg. § 301.6231(a)(3)-1(a)(4). Below is a list of items with respect to which the partnership must make a determination:

1. the character of the amount received from a partner (e.g., a contribution, a loan, a repayment of a loan);
2. the amount of money contributed by a partner;
3. the character of the amount transferred to a partner (e.g., a distribution, a loan, a repayment of a loan);
4. the amount of money distributed to a partner;
5. the amount transferred from the partnership to a partner or from a partner to the partnership in any transaction to which I.R.C. § 707(a) applies;
6. the character of such an amount (e.g, a loan, a repayment of loan); and
7. the percentage of the capital interests and profits interests in the partnership owned by each partner.

Treas. Reg. §§ 301.6231(a)(3)-1(c)(2), (3) and (4). The failure by the partnership actually to make such a determination does not prevent an item from being a partnership item. Treas. Reg. § 301.6231(a)(3)-1(c)(1).

In this case, [redacted] treated the transfer of the [redacted] and [redacted] to it by [redacted] as a contribution of capital. You argue that the transfer constitutes a sale between [redacted] and [redacted]. Clearly, the amount of the contribution made by [redacted] to [redacted], if any, and the character of such contribution are partnership items. See Treas. Reg. § 301.6231(a)(3)-1(a)(4) and Treas. Reg. §§ 301.6231(a)(3)-1(c)(2), (3), and (4). Therefore, they must be determined at the partnership level.

Before you may conduct a partnership level proceeding, you must mail to each partner entitled to notice a Notice of Beginning of Administrative Proceeding ("NBAP"). I.R.C. § 6223(a). At the close of your examination, you will mail to each partner entitled to notice a notice of Final Partnership Administrative Adjustment ("FPAA") asserting a change in the amount and character of the contribution made by [redacted] to [redacted]. I.R.C. § 6223(a). You will do this even though you most likely will not have any adjustments to the income reported on [redacted]'s [redacted] U.S. Partnership Return of

Income, Form 1065, as a result of the partnership proceeding.[1] If and when you are prepared to issue the FPAA, we will assist you in drafting the language necessary to address the issue.

If you prevail on the issue of whether I.R.C. § 707(a) applies to the transfer of the [redacted] and [redacted] by [redacted] to [redacted], you will issue an affected item notice of deficiency to the Taxpayer in which you determine the amount of gain that the Taxpayer realized on the sale of the [redacted] and [redacted].[2]

An "affected item" is any item to the extent such item is affected by a partnership item. I.R.C. § 6231(a)(5). That is, an affected item is any nonpartnership item whose existence and amount depend on the existence and amount of a partnership item. Maxwell v. Commissioner, 87 T.C. 783, 790 (1986). There are two types of affected items: (1) those that only require a computational adjustment after the partnership proceeding is completed (a "computational affected item") and (2) those that require partner level determinations after the partnership proceeding is completed (a "substantive affected item"). See N.C.F. Energy Partners v. Commissioner, 89 T.C. 741, 744-745 (1987); see also Maxwell, 87 T.C. at 792.

Because an affected item depends on a partnership level determination, it cannot be tried as part of the partner's individual tax case until the conclusion of the partnership litigation. Maxwell, 87 T.C. at 792. As a result, the Service and the taxpayer must await the outcome of the partnership proceeding before making a claim for any additional deficiency or refund attributable to the affected item. See id.

In this case, the existence of any gain realized by [redacted] on the transfer of the [redacted] and [redacted] depends on the treatment of the transfer made by [redacted] to [redacted], whether as a contribution as claimed by [redacted] or as a sale

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[1] The issuance of an FPAA without any adjustments to income may seem incorrect. We note, however, that the Service issues FPAA's to adjust the allocation of income and loss among the partners of a partnership pursuant to I.R.C. § 704(b). In that circumstance, the Service is not adjusting the income or loss of the partnership; it is adjusting the income or loss of the partners. That circumstance is much like the one in this case.

[2] You will issue the affected items notice of deficiency within one year after the decision in the partnership proceeding becomes final. See I.R.C. § 6229(d).

(or part-sale, part-contribution) as claimed by the Service. As discussed above, the amount and character of the transfer to [redacted] is a partnership item. In addition, the amount of gain depends, in part, on the amount treated as a contribution and the amount treated as the amount realized as a result of the sale. Consequently, the amount of gain realized by [redacted] on the transfer of the [redacted] and [redacted] is an affected item. And the amount of gain is a substantive affected item, because it requires a determination of a nonpartnership item, [redacted]'s basis in the assets sold to [redacted]. See Treas. Reg. § 301.6231(a)(3)-1(c)(4).

In summary, you potentially will issue three notices in this case: an NBAP at the commencement of the examination of [redacted], an FPAA at the conclusion of the examination of [redacted], and an affected items notice of deficiency to the Taxpayer within one year after the decision in the partnership proceeding involving [redacted] becomes final.

II. CONSENTS TO EXTEND PERIOD OF LIMITATIONS

You should have the Tax Matters Partner ("TMP") of [redacted] execute a Form 870-P, Consent to Extend the Time to Assess Tax Attributable to Items of a Partnership, to extend the period of limitations beyond the 3-year period prescribed by I.R.C. § 6229(a). See I.R.C. § 6229(b). Because I.R.C. § 6229(a) applies to both partnership items and affected items, Form 870-P also serves as an extension of the period of limitations with respect to affected items. See I.R.C. §§ 6229(a) and (b). You do not need the TMP or the Taxpayer to execute a separate consent with respect to affected items.

If you have any questions, please call the undersigned at (619) 557-6014.

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By: _____
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